I. INTRODUCTION

Off-balance sheet fee producing activities can improve earnings ratios which use assets as a component since earnings generated from these activities are included in income while total assets are not affected. Because the activities remain off the balance sheet, capital to asset ratios are not adversely affected regardless of the volume of business conducted. From a regulatory perspective, concern arises since these contingent liabilities subject a bank to certain risks, including credit risk. Many of the risks involved in these off-balance sheet activities are indeterminable on an offsite monitoring basis.

An evaluation of off-balance sheet lending activities should apply the same general examination techniques that are used in the evaluation of a direct loan portfolio. For example, banks with a material level of contingent liabilities should have written policies addressing such activities adopted and approved by their board of directors. The policies should cover credit underwriting standards, documentation and file maintenance requirements, collection and review procedures, officer lending limitations, customer borrowing limits, large exposures requiring committee or board approval, and periodic reports to the board of directors. Overall limits on these contingent liabilities and specific sublimits on the various types of off-balance sheet lending activities, either as a dollar amount or as a relative percentage (such as a percent of total assets or capital), should also be considered.

In reviewing individual credit lines, all of a customer's borrowing arrangements with the bank (e.g., direct loans, letters of credit, and loan commitments) should be considered, and many of the factors analyzed in evaluating a direct loan (e.g., financial performance, ability and willingness to pay, collateral protection, future prospects) are also applicable to the review of such contingent liabilities as letters of credit and loan commitments. When analyzing these off-balance sheet lending activities, examiners should also evaluate the probability of draws under the bank's lending arrangements with its customers and whether the allowance for loan and lease losses adequately reflects the risks inherent in off-balance sheet lending activities. Consideration should also be given to legal lending limits, including the provision of Part 337 of the FDIC Rules and Regulations which generally requires standby letters of credit to be included when determining any legal limitation on loans to one borrower.

II. ADVERSELY CLASSIFIED CONTINGENT LIABILITIES

For examination purposes, Category I contingent liabilities are defined as those which will give rise to a concomitant increase in bank assets if the contingencies convert into actual liabilities. Such contingencies should be evaluated for credit risk and, if appropriate, listed for Special Mention or subjected to adverse classification. This examination treatment does not apply to Category II contingent liabilities where there will be no equivalent increase in assets if a contingency becomes a direct liability. Examination treatment of Category II contingencies is covered in the Contingent Liabilities Section of this Manual.

Classification of Category I contingencies is dependent upon two factors: the likelihood of the liability becoming direct and the credit risk of the potential acquired asset. *Any contingent liabilities that are adversely classified or listed for Special Mention should be described on the examination report pages for Items Subject to Adverse Classification or Items Listed For Special Mention. These descriptions should be under separate headings for contingent liabilities. Adversely classified contingencies should be excluded from calculations comparing adversely classified loans to total loans. They should be included in calculations relating total adverse classifications to Tier 1 Capital and the Allowance for Loan and Lease Losses.*

Adverse classification and special mention definitions for direct loans are set forth in the Loans Section of this Manual. The following adverse classification and special mention criteria should be viewed as a supplement to those definitions and should be considered when evaluating the credit risk in contingent liabilities:

> **Special Mention - The chance of the contingency becoming an actual liability is at least reasonably possible, and the potential acquired assets are considered worthy of special mention. An example would be the undrawn portion of a poorly supervised accounts receivable line wherein the drawn**

portion is special mentioned.

Substandard - The chance of the contingency becoming an actual liability is at least reasonably possible, and the potential acquired assets are considered no better than Substandard quality. Undisbursed loan funds in a speculative real estate venture in which the disbursed portion is classified Substandard and the probability of the bank acquiring the underlying property is high would be an example of a Substandard contingency.

Doubtful - The chance of the contingency becoming an actual liability is probable, and the potential acquired assets are considered of Doubtful quality. Undisbursed loan funds on an incomplete construction project wherein cost overruns or diversion of funds will likely result in the bank sustaining significant loss from disposing the underlying property could be an example of a Doubtful contingency.

Loss - The chance of the contingency becoming an actual liability is probable, and the potential acquired assets are not considered of bankable quality. A letter of credit on which the bank will probably be forced to honor draws that is considered uncollectible is an example of a Loss contingency. A Loss classification normally indicates that a balance sheet liability (specific reserve) should be established to cover the estimated loss. For further information as to when a contingency should be reflected as a direct liability on the balance sheet, refer to FASB 5, "Accounting for Contingencies."

The total amount of Category I contingencies should be reflected on the memorandum section of the Capital Calculations schedule; however, the "Potential Loss" and "Estimated Loss" designations do not apply. Loss classifications of Category I contingent liabilities are treated the same as asset classifications in determining Tier 1 Capital amounts and ratios, but contingent liability classifications are not included in adjustments to assets.

III. TYPES OF OFF-BALANCE SHEET LENDING

Standby Letters of Credit

A standby letter of credit (SBLC) is an irrevocable commitment on the part of the bank issuing the SBLC to make payment to a designated beneficiary if the bank's customer, the account party, defaults on an obligation. SBLCs can be either financial- oriented, where the account party is to make payment to the beneficiary, or project-oriented where a service is to be performed by the account party. SBLCs are issued for a variety of purposes such as (1) to improve the credit ratings for issuers of industrial development revenue (IDR) bonds and commercial paper; (2) to provide back-up facilities for loans granted by third parties; (3) to assure performance under construction and employment contracts; and (4) to ensure the account party satisfies financial obligations payable to major suppliers or under tax shelter programs. An SBLC differs from a commercial letter of credit in that the latter facilitates the sale of goods and is expected to be drawn upon by the beneficiary in the normal course of business whereas the SBLC is not, generally, expected to be utilized unless the account party defaults in meeting an obligation to the beneficiary. Commercial letters of credit not sold for cash do, however, represent contingent liabilities and should be accorded examination treatment as such. Refer to the International Banking section of this Manual for further details on commercial letters of credit.

While no particular form is required for a standby letter, it should contain certain descriptive information. First, there should be a separate binding agreement wherein the account party agrees to reimburse the bank for any payments made under the SBLC. The actual letter should be labeled as a "standby letter of credit," be limited in amount, cover a specific time period, and indicate the relevant information that must be presented to the bank before any draws will be honored by the bank due to the account party's failure to perform. Since the bank is not a party to the contract between the account party and the beneficiary, the SBLC should not be worded so as to involve the bank in making determinations of fact or law at issue between the parties.

The two primary areas of risk relative to SBLCs are credit risk, or the possibility of default on the part of the account party, and funding risk, or the potential inability of the bank to fund from normal sources a large draw, such as a draw under a

commercial paper back-up facility. An SBLC is a potential extension of credit and should be evaluated in a manner similar to that for evaluating a direct loan. The element of risk could be significant under an SBLC given its irrevocable nature, especially if the SBLC is written for an extended period of time. Whereas deterioration in the financial position of a customer could allow for a direct loan commitment to be rescinded if the commitment contained a "material adverse change" clause, such would not be applicable with an SBLC as the latter is an irrevocable agreement between the bank and the beneficiary. Some SBLCs may have an automatic renewal provision and will roll over until notice of cancellation is given by either the bank or beneficiary prior to a maturity date. However, notice given by the bank usually allows the beneficiary to draw under the letter irrespective of whether the account party is performing.

SBLCs, like loans, can be participated and syndicated. Unlike loans, however, the sale of SBLC participations does not diminish the total contingent liability of the originating bank. The name of the originating bank is on the actual letter of credit, and it must therefore honor all drafts whether or not the participants are willing or able to disburse their pro rata share. Syndications, on the other hand, represent legal apportionments of liability. If one of the banks fails to fulfill its obligation under the SBLC, the remaining banks are not liable for that bank's share.

Section 337.2(d) of the FDIC Rules and Regulations requires banks to maintain adequate controls and subsidiary records of SBLCs comparable to records maintained on direct loans so that a bank's total liability may be determined at all times. Banks are also required to adequately reflect all SBLCs on published financial statements. Standby letters of credit should be covered in the bank's loan policy. Officers' approval authority should be addressed as well as the necessity of including SBLCs as part of the total loan relationship of the customer in order to ensure that legal lending limits and in-house credit limits are properly observed. Credit files should be kept current as to the status of SBLCs, and reports should be provided on a regular basis to the directors on the volume of standby letters, with a breakdown by type as well as by industry. This report will enable any concentrations to be monitored so that steps can be taken to reduce any undue exposure should economic or financial trends so dictate.

It may be appropriate to adversely classify or special mention an SBLC if draws under the SBLC are probable and credit weaknesses exist. For example, deterioration in the financial standing of the account party could jeopardize performance under the letter of credit and result in a draw by the beneficiary. If a draw under an SBLC were to occur, the offsetting loan to the account party could then become a collection problem, especially if it was unsecured.

Loan Commitments

A formal loan commitment is a written agreement, signed by the borrower and lender, detailing terms and conditions under which a loan of up to a specified amount will be made. The commitment will have an expiration date and, for agreeing to make the accommodation, the bank will usually require a fee to be paid and/or require the maintenance of a stipulated compensating balance by the customer. A commitment can be irrevocable, like a standby letter of credit facility, operating as an unconditional guarantee by the bank to lend when called upon to do so by the customer. In many instances, however, commitments are conditioned on the maintenance of a satisfactory financial standing by the customer and the absence of default in other covenants.

Some commitments are expected to be used, such as a revolving working capital line for operating purposes or a term loan facility wherein the proceeds will be used for such purposes as equipment purchases, construction and development of property, or acquisitions of other companies. Other commitments serve as backup facilities, such as for a commercial paper issue, whereby usage would not be anticipated unless the customer was unable to retire or roll over the issue at maturity.

Less detailed than a formal loan commitment is a line of credit which expresses to the customer, usually by letter, a willingness to lend up to a certain amount over a specified time frame, frequently one year in duration. These lines of credit are disclosed to the customer and are referred to as "advised" or "confirmed" lines, in contrast to "guidance" lines which are not made known to the customer but are merely used by the bank as lending guidelines for internal control

and operational purposes. Many lines of credit are cancelable if the customer's financial condition deteriorates, while others are simply subject to cancellation at the option of the bank.

Disagreements can arise as to what constitutes a legally binding commitment on the part of the bank. Descriptive terminology alone, as used by the bank, might not always be the best guideline. For example, a credit arrangement could be referred to as a revocable line of credit but at the same time may be a legally binding commitment to lend, especially if consideration has been given by the customer for the bank's promise to lend and if the terms of the agreement between the parties result in a contract. It is important for the bank to identity the extent of its legally binding commitments and its revocable commitments to ensure that the bank's position is properly documented and legally defensible should the bank ever contemplate canceling a loan commitment.

Credit facility documentation frequently contains a so-called "material adverse change" (MAC) clause, which is intended to allow the bank to terminate the commitment or line of credit arrangement if the customer's financial condition deteriorates. The extent to which MAC clauses are enforceable depends on several factors, including whether a legally binding relationship continues to exist when specific financial covenants are violated or whether the documents make only a vague reference to a borrower's responsibility for maintaining a satisfactory financial condition in order to preserve the commitment.

Although the enforceability of MAC clauses may be subject to some uncertainty, such clauses, nonetheless, may provide the bank with leverage in negotiations with the customer over such issues as requests for additional collateral or personal endorsements.

Whether funding of a commitment or line of credit will be required cannot always be determined in a routine manner. Careful analysis will frequently be necessary. A MAC clause could allow the bank to refuse funding to a financially troubled borrower, and a default in other covenants might also be a means of canceling the commitment or line of credit. Some banks might strictly construe the terms of a legally binding credit arrangement and refuse funding if any of the covenants are broken whereas others might take a more accommodating approach and feel an obligation to make advances short of a bankruptcy situation. A similar approach might also be taken where the arrangement is not legally binding. In the final analysis, the procedure normally followed by the bank in acceding to or denying take down requests where adverse conditions have arisen is an important consideration in the examiner's overall evaluation of the credit risk.

In the Memorandum Section of the Capital Calculations schedule, the undisbursed portion should be reflected for all commitments or lines of credit for which the bank has received a fee or other consideration or for which the bank otherwise has a legally binding commitment. In a footnote to the schedule, the amount of commitments or disclosed lines which are not legally binding should be shown for informational purposes, if significant. The Contingent Liabilities Memorandum item should not include commitments under retail credit cards, check credit and related plans.

In assessing the adequacy of a bank's asset/liability management program, it is important to evaluate the anticipated usage of loan commitments and lines of credit relative to anticipated funding sources. At each examination, the amount of funding that is anticipated for unused commitments and disclosed lines of credit should be estimated. If the amount is large relative to the bank's liquidity position, completion of the Cash Flow Projection workpaper is suggested to give some indication of cash availability and whether borrowings will have to be utilized to meet anticipated draws. For further information, refer to the Liquidity and Funds Management Section of this Manual.

Revolving Underwriting Facilities

A revolving underwriting facility (RUF) (also referred to as a note issuance facility (NIF)) is a commitment by a group of banks to purchase at a fixed spread over some interest rate index, the short-term notes which the issuer/borrower is unable to sell in the Euromarket at or below this predetermined rate. In effect, the borrower anticipates selling the notes as funds are needed at money market rates but, if unable to do so, has the assurance that credit will be available under the RUF at a maximum spread over the stipulated index. A lead bank generally arranges the facility

and receives a one-time fee, and the revolving underwriting facility banks receive an annual commitment or underwriting fee. When the borrower elects to draw down funds, placement agents arrange for a sale of the notes, and normally receive compensation based on the amount of notes that are placed. The notes usually have a maturity range of 90 days to one year and the purchasers bear the risk of any default on the part of the borrower. There are also standby RUFs which are commitments under which Euronotes are not expected to be sold in the normal course of the borrower's business.

Inability to sell notes in the Euromarket could be the result of a financial deterioration on the part of the borrower, but it could also be due to volatile short-term market conditions which precipitate a call by the borrower on the participating banks for funding under the RUF arrangement. The evaluation of RUFs by the examiner will follow the same procedures used for the review of loan commitments. An adverse classification should be accorded if it is determined that a loan of inferior quality will have to be funded under a RUF. For examination report purposes, the total of the unfunded RUFs outstanding will be reflected in the Memorandum Section of the Capital Calculations schedule, and any anticipated funding of these commitments by the bank should be considered in reviewing the bank's liquidity position.

Bankers Acceptances

The following discussion refers to the roles of accepting and endorsing banks in bankers acceptances. It does not apply to banks purchasing other banks' acceptances for investment purposes. Bankers acceptances may represent either a direct or contingent liability of the bank. If the acceptance is created by the bank, it constitutes a direct liability which must be paid on a specified future date. If a bank participates in the funding risk of an acceptance created by another bank, the liability resulting from such endorsement is only contingent in nature. In analyzing the degree of risk associated with these contingent liabilities, the financial strength and repayment ability of the accepting bank should be taken into consideration. Further discussion of bankers acceptances is contained in the International Banking Section of this Manual under the heading "Trade Financing."

Loans Sold Without Recourse

Loans sold without recourse are generally not a contingent liability, and the bank should reflect on its books only that portion of participated loans it has retained. However, some banks may follow the practices of repurchasing participations and absorbing any loss on such loans even when no legal responsibility exists. It is necessary to determine management's attitude toward repurchasing these assets in order to evaluate the degree of risk involved. Contingent liabilities may also result if the bank, as seller of a loan participation without recourse does not comply with provisions of the participation and/or loan agreement. Noncompliance may result from a number of factors, including failure on the part of the selling institution to receive collateral and/or security agreements, obtain required guarantees, or notify the purchasing party of default or adverse financial performance on the part of the borrower. The purchaser of the participation may also assert claims against the bank on the basis that financial information relied upon when acquiring the loan was inaccurate, misleading or fraudulent and the bank as a seller was aware of this fact. Therefore, a certain degree of risk may in fact be evident in participation loans allegedly sold without recourse. Examiners need to be mindful of this possibility and the financial consequences it may have on the bank under examination. Further discussion of loan participations is contained in the Loans Section of this Manual.

Loans sold with recourse are not discussed in this section because for examination purposes, such loans are not treated as being sold. Rather, the loans remain as balance sheet assets and the proceeds raised from transferring the loans with recourse are reflected as borrowings. The examination procedures described in the Loans Section of this Manual for direct loans would therefore apply to loans sold with recourse.